LONG TERM DEBT AND EQUITY CAPITAL AVAILABILITY TO SMALL BUSINESS

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SUMMARY

The growth of business is closely related to the availability of capital, be it internally generated or externally procured. It is the view of this submission that the development of growing, smaller businesses in Canada may be handicapped by a deficiency in the capital market to provide long term debt and equity capital to small business in sufficient quantity and at reasonable terms.

In analyzing the present sources of capital and in trying to assess the needs of small business for such capital, one must always fall back on assumptions or use data compiled in other countries as there is a serious void in statistical sources covering small business activities and knowledge of the relationships of various segments of the capital market towards small business. It is virtually impossible under these circumstances to state intelligently the needs of small business and suggests how, in the light of clearly discernible needs, changes can be brought about in the capital market to meet the needs. The first and utmost requirement then amounts to a plea for more information and analysis of this problem so that whatever remedial action is required can be taken intelligently.

If one assumes that there is a void in the capital market insofar as long term debt and equity capital availability for small business is concerned, then the experience of other countries dealing with the same problem should be studied. The most pertinent experiment in small business finance has occurred in the United States recently with the introduction of legislation which created a large number of Small Business Investment Companies. Canada should be able to learn and gain from this experiment insofar as both the benefits and shortcomings of this legislation are now becoming apparent.

In helping small business, it is the stated objective of this submission to insure that growing successful businesses and promising, serious new enterprises have access to long term capital. It

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is not the intention to seek financial help which by its very nature would tend to subsidize all small ventures and insure the survival of marginal or uncompetitive businesses. It is more important now than ever before to make sure that Canadian industry and commerce be competitive at all size levels. In order to encourage the sound, growing small or new enterprise, sufficient capital should be available on reasonable terms. A two-prong approach is suggested:

1) In order to increase internal cash generation, the lower rate of corporate income tax which is now applicable on the first $35,000 could be applied on a larger amount, say $50,000. In view of the recent changes in the Income Tax Act with respect to associated companies which eliminate certain past abuses, and which presuppose closer scrutiny of this avenue of tax avoidance, this change would increase internal sources of capital without creating an undesirable tax shelter.

2) In order to increase external sources of capital for small business, legislation should be considered which would bring about the formation of a new class of investment company devoted to investments in small business. Such an investment company, operating under charter of a federal authority, would have the right to borrow from a new crown corporation, which would loan funds up to a prescribed ratio of the investment company's paid-in capital and surplus. Secondly, such an investment company, in view of certain risks it would be bound to take, should have the rights to apply any capital losses against any taxable income over a specified period of time.

It is also recommended that the new crown corporation would assume direction of all government activities in the small business field and would logically be responsible to the Department of Trade and Commerce. The crown corporation should, therefore, take responsibility towards not only the proposed investment companies, but also the Industrial Development Bank. As this bank is a

promotor of industrial activity rather than a tool of monetary policy, such a realignment seems appropriate. The new crown corporation should also be active in non-financial assistance to small business; namely it should assume an educational and informational role, stimulating greater awareness in small business management of the breadth of skills required by management in to-day's highly competitive industrial environment.

1. This brief being concerned with the limited sources of long term debt and equity financing for small business in Canada will analyze present sources of such capital and consider potential remedies to overcome the apparent deficiencies.

2. In the first instance what is meant by small business? Small business was defined a year ago by the Small Businesses Loans Act as business with gross revenue less than $250,000. This concept of smallness is a confining one. An American definition of small business is provided by the Small Business Administration for the purposes of Small Business Investment Companies and consists of three qualifications: 1) Assets under $5,000,000., 2) Average after tax income of less than $250,000 for last two years, and 3) Net worth under $2,500,000. This definition allows for broader scope than the Canadian definition.

3. This brief's quantitative definition of small business[1] is aimed well above the Small Businesses Loans Act's definition, and somewhat below the U.S. Small Business Administration definition. In considering small business qualitatively, particularly at the secondary manufacturing level, it is not the purpose of this brief to concern itself with and recommend support for stagnating small business or uncompetitive small business. It is rather hoped that established, smaller businesses which are growing rapidly, businesses which, using Rostow's stages of economic growth analysis, are passing through the "take-off" stage, are not hampered in their growth by lack of long term debt or equity capital; and secondly that soundly conceived new ventures, with good prospects of success and growth, can be launched with sufficient long term capital.

4. The dynamics of an economy stem not only from large scale capital investment programs such as have been witnessed recently in Canada in the development of the St. Lawrence Seaway and Power Project or the natural gas distribution industry, but also

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1. For the purpose of this brief two areas are not being considered: i) unincorporated enterprises and ii) small businesses in the form of agricultural enterprise.

from the aggregate effect of small businesses growing. It is important to the well being of the economy that small growing businesses are not hampered by a lack of long term capital, and that sound new business opportunities find adequate sources of long term capital.

5. Canada's capital market offers certain sources of long term debt and equity capital to small businesses. Little, if any, statistical data is available on any of the sources outlined below:

Present sources of long term debt and equity capital

Sources of long term debt and equity financing for small business may be classified as follows:

6. (1) Individuals. Officers and directors, as individuals, are a dominant source of equity and debt capital for small business. Small business in its formative stage is largely the enterpreneurial endeavour of one or a limited number of individuals, who through their pooling of savings, supply the original capital for the venture. At the same time such a group may solicit savings of other individuals known to them. This vital source of venture capital is probably diminishing in importance as progressive income taxation and estate taxation tend to discourage the accumulation of personal wealth. No statistics are available on the role individuals play as a source of long term capital to new and small business and it is unlikely that this varied source of capital could be studied and documented.

7. (2) Trade Suppliers. Trade suppliers are frequently a source of short and intermediate credit particularly in the distribution and merchandising field. Though no statistical evidence is available, it may be assumed that long term credit or equity funds are not normally available through this channel.

8. (3) Commercial banks. Commercial banks are the basic source

of short and intermediate credit. Their function of providing working capital accommodation is supplemented to a degree by term loans. Canadian banks are not, in the normal course of their business, a source of equity funds. The Canadian banking system issues no data on loans by size of customer, term of loan, or underlying conditions.

9. (4) Finance or acceptance companies. Finance or acceptance companies are a source of intermediate credit, and are used quite heavily in certain businesses for the financing of inventories and indirectly as a sales aid through financing customer purchases. Finance companies are not normally a source of long term credit or equity capital.

10. (5) Institutions as a source of mortgage funds. Small business relies rather more heavily than large business upon long term credit available via mortgages against real estate. This is illustrated by studies in Taxation Statistics referred to later. Mortgage companies and insurance companies would, therefore, via mortgages against real property, be a source of long term capital to small business. No statistical evidence is available from these institutions on loans to small business.

11. (6) Leasing of properties and equipment as a source of funds. The leasing of buildings is a relatively common procedure for small and medium sized business which does not wish or cannot raise capital for the purchase and construction of buildings. The development of property companies and "industrial parks" has probably facilitated this form of financing and has lowered its cost. A long term lease is, therefore, a fairly common source of long term credit for small business.

12, The leasing of equipment is a more recent development, which is presently being accelerated by the entrance of well established acceptance companies into equipment leasing. Equipment leasing

normally is written over a period of 3-8 years and therefore would be generally equivalent to intermediate credit. No statistics are available on property or equipment leasing as a source of long term debt to small business.

13. (7) Factoring as a source of capital. As with equipment leasing, this is a relatively new source of funds in Canada and inasmuch as factoring steadily carries the receivables of a business, this source of financing can be considered to be short to intermediate in term. In the United States several factoring companies have built up sizeable businesses on the basis of performing not only a financial service by factoring receivables but also by acting as consultants and advisors to their clients in screening customers for credit worthiness, etc. The nature of factoring is such that this should not be considered a source of long term debt financing.

14. (8) Industrial Development Bank. The Industrial Development Bank was founded in 1944 as an adjunct to the Bank of Canada to promote "high and rising levels of employment" and make loans when "credit or other financial resources would not otherwise be available on reasonable terms." The powers of the Bank have been broadened periodically, the most recent expansion being in the Budget delivered in 1961. As opposed to the other sources of capital outlined previously, the activities of the Industrial Development Bank are well documented. Loans at the end of the last fiscal year, September 30, 1961, were about $154,000,000, spread over 2,768 individual loans. Though no details are given on the average term of these loans, the normal practice of the Industrial Development Bank is to grant intermediate term loans, the average maturity being in the order of 3-5 years. The growth of the Industrial Development Bank is a confirmation of the important and needed services which it provides to the Canadian economy.

Industrial Development Bank loans and commitments outstanding and number of customers (as of September 30th)

	Amount (millions)	No. of customers
1955	$ 52.3	693
1956	76.9	820
1957	88.3	1,022
1958	104.3	1,322
1959	109.3	1,609
1960	120.0	1,967
1961	154.2	2,768

Source: Industrial Development Bank, Annual Reports

15. The average size of loan, during the last three years, has been maintained somewhat in excess of $50,000, and though loans are not classified publicly by size of customer, it may be assumed that loans are made nearly exclusively to a size of business which conforms to this brief's definition.

16. The Industrial Development Bank maintains offices throughout the country and makes its services available near and far from the nation's financial centers. Loans, however, are heavily concentrated in Ontario and Quebec.

Industrial Development Bank. Geographical loan approval distribution

	1960 ($000)	%	1961 ($000)	%
Maritime Provinces	2,772	7.1	5,665	7.9
Quebec	9,398	24.4	16,914	23.8
Ontario	12,388	32.2	25,007	35.1
Manitoba	1,895	4.9	5,433	7.6
Saskatchewan	1,493	3.9	3,133	4.4
Alberta	3,465	9.0	5,990	8.4
B.C.	7,057	18.3	8,907	12.5
Yukon & N.W. Territories	108	0.2	147	0.2
Total	38,576		71,196	

Source: Industrial Development Bank, Annual Report 1961

17. In the first quarter of the Bank's present fiscal year, loans have expanded again and customers exceed 3,000 for the first time.[1]

1. Bank of Canada, Statistical Summary, January 1962.

18. The present operating procedure of the Industrial Development Bank is such that neither long term debt capital or equity capital is normally provided. In view of its operating history as a mortgage bank, bearing in mind the nature of collateral required for loans, and in view of the policy of a uniform interest rate, the Industrial Development Bank would probably be best limited to its present function as a mortgage bank, leaving the more speculative and difficult to appraise equity financing and 'unsecured' long term borrowing to private enterprise.

19. (9) Provincial development programs. Several provinces, including Newfoundland, New Brunswick, Manitoba and Saskatchewan have made financial aid available to new industries established within their boundaries, often by guaranteeing the debt of such businesses. As such, long term debt was made available to new businesses on a relatively favourable basis. In some instances the businesses so helped were of a size classification beyond this brief's definition. Though this could become an area of some importance, to date Provincial development programs have not been a major source of debt capital in Canada.

20. (10) Private regional development companies. Western Development and Power Limited, a wholly owned subsidiary of the B. C. Power Corporation, was for a time an active financial organization sponsored by the then privately owned electric utility. Western Development financed several new businesses adopting a flexible procedure which took into account all types of debt and equity financing. In a less institutionalized manner other utilities such as International Utilities in Alberta have made capital available to businesses within their service area, this capital largely being in the form of equity.

21. More recently Gatineau Power Company announced that a subsidiary, Gelco Enterprises Ltd., would utilize funds provided by compensation received for Gatineau's New Brunswick system to operate

as an investment and development company assisting enterprises in Western Quebec served by Gatineau. The cumulative effect of these various investment companies or divisions is hard to measure but clearly these development companies are making some long term capital available to small businesses within their area.

22. (11) Venture capital companies. There are few venture capital companies, as such, in Canada. Large holding companies like Argus Corp. Ltd. and Power Corp. of Canada Ltd. have on occasion made capital available to small business. Certain mining groups have ventured into smaller businesses, outside of mining. A number of companies exist which to a degree make capital available to small business: Canadian Corporate Management, Charterhouse of Canada, Triarch Corp. and United North Atlantic Securities Ltd., among others. It is hard to judge the impact of these operations, but it is smaller in scope than the activities of U.S. venture capital companies, such as: American Research and Development Corp., Payson & Trask, Rockefeller Bros., J. H. Whitney & Co., Transoceanic-A.O.F.C., etc., the first of which is now a public company with shares listed on the New York Stock Exchange.

23. (12) Investment dealers. Outside of speculative mining and oil issues, Canadian investment dealers seem to shun issues with a gross value of less than $1,000,000.00. Though in the last year there have been more smaller industrial issues brought to market, this activity has been performed often by the more speculative element of the dealer fraternity. The cost of marketing these issues has been high; commissions in the order of 10% and often options on stock added on; beyond this the company has further costs in the preparation of the prospectus, with its legal and accounting fees. In total these costs often appear sufficiently high so as to preclude this as a reasonable avenue to additional funds. In total, this source of debt or equity financing is not at present significant as far as small business is concerned.

24. Before summarizing what could be called external sources of long term debt and equity capital, internal sources of capital generation should receive mention. The cash generation power of business and in particular retained earnings, which are in effect additions to equity capital, are an all important source of capital to established and profitable business and have the advantage to management of being "new" funds which flow into the company without the test of the market place, and without any diluting effect upon existing shareholders. Small business receives some measure of encouragement in this area due to the lower rate of tax paid on the first $35,000 of taxable income. As the definition of Associated Companies has been tightened recently, and should be tightened further, it would seem reasonable to consider a higher amount than $35,000 at the lower rate of taxation. Internal sources of capital generation are, of course, not available to newly established business; in fact the reverse is true. New business ventures invariably have cash operating losses at the outset and require sufficient capital to overcome the period of cash loss.

25. In summary, the external sources of long term debt and equity capital to new and growing small business appear limited to:

a) Individuals

b) Institutions via mortgages against real property

c) Leasing of properties and equipment

d) Provincial development programs

e) Private regional development companies

f) Venture capital companies

g) Investment dealers

Of these b) and c) represent only debt sources whereas the others might be either or both sources of debt and equity capital. These sources, though in total non-measurable, provide

some supply of risk capital. It would be intriguing to know how many capital short, small business managements in Canada are familiar with such sources and have made a concerted effort to learn on what terms long term capital might be available. The U.S. experience on this count has been documented and is: "Among small businesses, reported dissatisfaction with long-term financing experience, for both equity capital and credit, reflected primarily lack of effort to get funds, because respondents assumed their efforts would not meet with success. For example, four-fifths of the small companies needing equity capital made no effort to get it. In contrast, more than half of the medium-size and about all of the large companies needing funds did make a financing effort."[1.] Two things appear to be required:

1) Larger regional sources of debt and equity capital through regional or provincial development companies or one or more national investment institutions, partially or wholly oriented towards the long term capital needs of small business,[2.] and

2) Education of small business management in the use and the derived benefits of such sources of capital. Neither of these objectives has any validity until the financial needs of small business can be clearly defined.

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1. "Small Business Financing: Corporate Manufacturers", Federal Reserve Bulletin, January 1961, p. 13.

2. The need for an institution is well outlined by A.D.H. Kaplan: "The greatest need is for an institution to which small business can bring its case for capital. There is no opportunity for small business to outline its plans for growth, indicate the type of capital it requires and secure advice on consideration of its plans. Small business could think in this manner if there were a point in so doing. As long as small business gets its capital in a haphazard way it will think in this manner."

   Federal Reserve System, Financing Small Business. Report to the Committee on Banking and Currency, 1958, p. 123.

26. Long term debt and equity capital requirements of small business

There is no way presently to measure the demand for long term debt and equity capital save the collective experience of investment officers and investors who deal in the small business area. The best picture available of the financial condition of Canadian small business by which its needs for capital might be approximated is provided by Taxation Statistics[1.] and reveals that generally speaking small business is fairly liquid, not particularly profitable, and seemingly not under-capitalized.

27. Exhibits 1-3 show composite balance sheets of small business, as derived from a sample of 1959 corporate returns. These tables tend to support the importance of certain sources of capital previously outlined. Advances from shareholders assume a particular importance with companies whose assets are less than $250,000 (Exhibit 1). Mortgage debt is an important source of long term capital to companies with assets in a range of $250,000 - $1,000,000 (Exhibit 2), whereas shareholder loans are relatively less important.

28. In each of the three composite balance sheets shown, corporate liquidity is adequate, the relationship of debt to equity quite favourable and dividends are being paid. On the basis of these figures why should one be concerned with small business capital needs? The answer turns back to the qualitative definition of small business, as made in this brief. It is the growing business which needs adequate and reasonable sources of capital to maintain its development. The sample of companies used covers by necessity, companies in every stage of their economic growth. It is reasonable to assume that the growing company in a dynamic stage of development is always the exception rather than the rule in small business, as it is in big business. In a composite picture its problems would not stand out, being surrounded in all likelihood by static, mature businesses

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1. Department of National Revenue, 1961 Taxation Statistics, Ottawa, 1961.

EXHIBIT 1

BALANCE SHEET OF A TYPICAL COMPANY WITH ASSETS LESS THAN $250,000 BASED ON SAMPLE OF 64,265 COMPANIES. (Table 5, p.146-7, 1961 Taxation Statistics)
BASED ON 1959 TAXATION RETURN

ASSETS			LIABILITIES		
Cash and government securities		$ 5,418	Bank loans		$ 7,351
Accounts receivable		17,553	Accounts payable		14,991
Inventories		15,274	Tax liabilities		1,073
		38,245			23,415
Land		$ 4,445	Due shareholders		$ 7,540
Building and Equipment	$ 29,515		Deferred income		1,063
Less: depreciation	11,376	18,139	Mortgage debt		4,623
Investment in affiliates		2,206	Other funded debt		1,529
Other securities		4,462	Other liabilities		5,217
Intangibles		4,005			
Other assets		1,802	Preferred shares		5,782
			Common shares		10,352
			Surplus		13,783
		73,304			73,304
Working capital		14,830			
Current ratio		1.6	Net worth	$ 29,917	
Annual sales		139,263	Pre-tax return on net worth	13.2%	
Profit before taxes		3,960			
Dividends paid		779			
Pre-tax return on sales		2.8%			

EXHIBIT 2

BALANCE SHEET OF A TYPICAL COMPANY WITH ASSETS IN RANGE OF $250,000 to $1,000,000
BASED ON SAMPLE OF 16,317 COMPANIES. (Table 5, p. 146-7, 1961 Taxation Statistics)
BASED ON 1959 TAXATION RETURN

ASSETS			LIABILITIES	
Cash and government securities		$ 22,222	Bank loans	$ 46,871
Accounts Receivable		90,108	Accounts payable	68,119
Inventories		81,448	Tax liabilities	6,368
Total current assets		193,778	Total current liabilities	121,358
Land		$ 28,197	Due shareholders	$ 19,341
Building and equipment	$ 170,208		Deferred income	8,072
Less: depreciation	72,580	97,628	Mortgage debt	33,848
Investment in affiliates		22,664	Other debt	15,683
Other securities		37,299	Other liabilities	36,458
Intangibles		8,377		
Other assets		14,622	Preferred shares	25,592
			Common shares	44,407
			Surplus	97,806
		402,565		402,565

Working capital	72,420		
Current ratio	1.6	Net worth	$167,805
Annual sales	619,298	Pre tax return on net worth	11.2%
Profit before taxes	18,790		
Dividends paid	5,570		
Pre tax return on sales	3.2%		

EXHIBIT 3

BALANCE SHEET OF A TYPICAL MANUFACTURING COMPANY WITH ASSETS IN RANGE OF $250,000 - $1,000,000. BASED ON SAMPLE OF 3,713 COMPANIES. (DERIVED FROM TABLE 5A, p.148-9, 1961 TAXATION STATISTICS). BASED ON 1959 TAXATION RETURN

ASSETS			LIABILITIES		
Cash and government securities		$ 22,084	Bank loan		$ 55,642
Accounts receivable		100,969	Accounts payable		69,593
Inventories		114,974	Tax liabilities		9,183
		238,027			134,418
Land		$ 9,668	Due shareholders		$ 14,679
Building and equipment	$202,127		Deferred income		3,474
Less: depreciation	102,989	99,138	Mortgage debt		8,537
Investment in affiliates		16,132	Other funded debt		15,189
Other securities		17,263	Other liabilities		34,500
Intangibles		10,126			
Other assets		8,779	Preferred shares		25,802
			Common shares		43,091
			Surplus		119,443
		399,133			399,133
Working capital		$103,609			
Current ratio		1.7	Net worth	$188,336	
Annual sales		$698,437	Pre-tax return on net worth	12.9%	
Profit before taxes		24,373			
Dividends paid		3,985			
Pre-tax return on sales		3.5%			

which are frequently characterized by a build up of liquid assets and therefore not in demand for new capital.

29. Secondly these figures naturally cannot indicate the financial needs of new business, the second area of small business, as definied in this brief. Statistics on new business incorporations are available for manufacturing and indicate certain basic trends. The two tables shown below indicate that most new manufacturing ventures are small in terms of employees hired and are started by Canadians.

New manufacturing establishments started 1950-60 by employment size group

	No. of companies
Under 5 employees	10,235
5 - 14 employees	4,100
15 - 24 employees	1,053
25 - 49 employees	822
50 - 99 employees	310
100 and over	207
	16,727

New manufacturing establishments started 1950-60 by country of origin

Canada	15,793
U.S.A.	757
U.K.	106
Other	71
	16,727

Source: New manufacturing establishments in Canada, June 1961 Dominion Bureau of Statistics.

30. The rate at which new manufacturing businesses have been established accelerated in early 50's to a peak in 1955-6. With the exception of 1959, which saw a record number of new businesses established, the trend now appears downward.

New manufacturing establishments started

1950	1035
1951	1303
1952	1426
1953	1321
1954	1374
1955	1914
1956	1734
1957	1405
1958	1679
1959	2291
1960	1245

Source: New Manufacturing establishments in Canada, June 1961 Dominion Bureau of Statistics.

31. The three largest industrial groupings among new businesses were: 1) wood industries, 2) food and beverage industries, and 3) metal fabricating. Among new business of foreign origin metal fabricating, chemical products and electrical products predominated. Though data is not available, it is reasonable to presume that new businesses of foreign origin would start on a larger scale than domestically started business. In the case of branch plants, these are often established only after a domestic market has been established through imports. It is further less likely that a foreign new business, particularly a branch plant, would require capital. The capital requirements one may assume would come from domestically originated new, small business ventures.

32. In discussing the demand for long term capital by small business, two areas have been emphasized: namely growing business and new business. A third area exists which, though not a dynamic force in the economy, nevertheless presents a specific need; this is the capital required by small private businesses which are faced with either a succession duty or a change in ownership problem. This is yet another area of small business capital needs which is generally undocumented and requires careful appraisal.

33. At various times experts have commented on the demand for capital by small business in Canada; two recent expert opinions are: "If small business in Canada is being regularly deprived of capital funds simply because of some anomaly of the capital market, it is not glaringly obvious."[1] A bolder statement is made by W. F. Lougheed in his study of secondary manufacturing industries in Canada. "Long term risk capital to-day, even in Canada, is sufficiently plentiful to permit the establishment of new industries if the prospects are attractive for the rewards of risk. There are, in short, entrepreneurs with sufficient funds to suffer a few lean years in exchange for the prospects of many lush ones."[2] Lougheed

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1. Wm. C. Hood, <u>Financing of economic activity in Canada, 1958</u>, p.293.

2. W. F. Lougheed, <u>Secondary Manufacturing Industry in the Canadian Economy</u>. Baxter Publishing Company, Toronto, 1961, p.131.

does not make a distinction between risk capital for small or large business, but the implication is that there is enough for everybody. These expert opinions appear diametrically opposite to prevalent U.S. analysis of the subject, and to the general tenor of this brief.

34. Typical of an American expert opinion is Wendell B. Barnes, Administrator, Small Business Administration: "Equity capital and long-term loans for growth and development purposes have never been readily available to small business. Commercial banks furnish short and intermediate term loans, but not venture capital and long term credit. Existing institutions which could provide venture capital are not able to assist smaller firms, since the cost for public sale of securities is disproportionately high to small business issuers."[1.]

35. In early 1959, the Harvard Business Review sponsored a survey on small business financing.[2.] The questionnaire used asked for an appraisal of sources of long term debt and equity capital for small business; almost two-thirds of all respondents were in wide agreement as to the need for additional sources, although smaller manufacturers, retailers and wholesalers and financial institutions showed more concern about this than larger manufacturers.

36. In early 1961, the Federal Reserve System published findings from probably the most exhaustive study made recently of external financing by business in various size categories. The table shown as Exhibit 4 clearly indicates that in the field of long term credit and equity capital, small business has needs which, relative to medium and large business, are not being met.

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1. Small Business Administration. Equity Capital and Small Business. Washington, 1960, p. 69.

2. Clifford L. Fitzgerald, Jr. Small Business Financing. Harvard Business Review, March-April 1959.

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capital and [illegible] loans for [illegible] development purposes [illegible] capital and [illegible] capital [illegible] since the [illegible] public [illegible] small business [illegible].[1]

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[illegible] published [illegible] small business [illegible] categories. The [illegible] and [illegible] small business [illegible], are not being met.

1. Small Business [illegible], [illegible], Washington, [illegible], p. [illegible].

Size of company and type of financing related to financing experience

(percentage of all manufacturing corporations in each size group)

Financing experience	Small	Medium	Large
		Short-term credit	
Total in scope	100.0	100.0	100.0
Total response	81.8	83.9	94.5
No need for funds	44.5	38.7	45.3
Needed funds	37.3	45.2	49.8
Needs met satisfactorily	26.3	39.9	48.3
Experience not satisfactory	11.0	5.2	1.5
No financing efforts made	4.3	1.2	0.5
		Long-term credit	
Total in scope	100.0	100.0	100.0
Total response	81.7	84.0	94.5
No need for funds	64.1	66.0	70.1
Needed funds	17.6	18.0	24.4
Needs met satisfactorily	5.9	11.7	20.9
Experience not satisfactory	11.7	6.4	3.5
No financing efforts made	8.4	3.6	2.0
		Equity capital	
Total in scope	100.0	100.0	100.0
Total response	81.8	83.9	94.5
No need for funds	68.2	69.9	52.7
Needed funds	13.5	14.1	42.3
Needs met satisfactorily	1.4	6.2	36.3
Experience not satisfactory	12.2	7.9	6.0
No financing efforts made	10.7	6.7	3.0

(Note: Details may not add to totals because of rounding.)

Source: Board of Governors of the Federal Reserve System. Federal Reserve Bulletin, January 1961, p.12.

In summary; "the extent to which financing needs were met satisfactorily varied substantially by type of financing needed. Almost three-fourths of the small companies needing short term credit were able to obtain such funds in amounts and on terms they regarded as satisfactory. In the long term credit area, however, only one-third of the small companies needing funds obtained them on a satisfactory basis, and only one-tenth of those needing equity capital were satisfied."

37. When one considers the U.S. experience and the relatively few sources of long term debt and equity capital available in Canada, it is reasonable to assume that there is a demand for venture capital in Canada which is not being met by the capital market. Obviously a great deal of research is required to pin point the nature of this demand. It is a difficult field to study for those about to be helped will be highly suspicious and probably highly uncooperative with anyone endeavouring to find out about their financial requirements.

38. In the United States the Federal Reserve System, Small Business Administration and the Select Committee on Small Business, U. S. Congress have undertaken many studies in this field. In Canada no effort of a comparable magnitude has been made. More is needed here than expert opinions. Before serious thought can be given to remedial action to satisfy the assumed demand for capital by small business, that demand will have to be studied in detail.

39. Present Government financial aids to small business

The Government, recognizing in broad terms the financial problems of small business, has provided certain incentives and financial assistance to small business. Among the more important incentives is the lower rate of corporate tax on the first $35,000 of taxable income. In the area of financial assistance, the Industrial Development Bank with its enlarged powers is performing an

important role in small business finance. More recently the Small Businesses Loans Act was established to make available through chartered banks, loans up to $25,000 with a maximum term of ten years, with the Government guaranteeing each bank against loss up to 10% of the loans made. From the inception of the small loan program on January 19, 1961 to the end of December 1961, 2,977 loans were made with a total value of $25,582,269.41 and an average loan value of $8,593.[1.] When conceived in late 1960, it was hoped that small business, particularly in the distributive trades, could utilize quickly a major portion of the $300,000,000 which the Crown was prepared to guarantee to the chartered banks. The Small Businesses Loans Act has not seemingly lived up to expectation, which may indicate that at the time it was written too little was known of the demand for credit which the Act was endeavouring to meet. If this assumption is valid, it underlines the importance of research to ascertain the financial demands of small business before legislation is enacted to meet it.

40. New business also received a modest stimulus in 1961 through special capital cost allowances under the New Products Programme which allows for up to double normal depreciation in the first year on most equipment acquired for the production of new products in Canada or new products to surplus manpower areas. No figures are available yet on the use business has made of this provision of the Income Tax Act. Though it is a departure in the right direction, it is only a modest stimulus compared to what many countries in the world offer by way of tax incentives to newly established business. The New Products Programme, it should be noted, however, makes no concession to business by size.

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1. House of Commons, Official Report, February 26, 1962, p.1243.

All categories of size are treated equally, the intention being to stimulate the introduction of new products; it seems that the depreciation advantages offered are actually more attractive to already established, larger business rather than to new, small business.

41. Present government non-financial aids to small business

The non-financial problems of small business are most lucidly shown by data on business failures. In 1960, the following were the causes of business failures:

Classification of causes of business failures in Canada, 1960.

	%
Neglect	2.1
Fraud	0.5
Lack of experience in the line	15.2
Lack of managerial experience	32.8
Unbalanced experience	14.8
Incompetence	33.6
Disaster	0.5
Reason unknown	0.5

Age of 1960 Canadian failures
(The year in which concerns that failed in 1960 started in business)

	%
1960	4.5
1959	18.6
1958	16.7
1957	9.3
1956	8.1
1955	7.8
	65.0

Source: Research Division, Dun & Bradstreet of Canada Ltd., Toronto.

42. On the basis of 1960 experience it would appear that 65% of all failures occur in businesses established for five years or less. The reasons for failure appear basically managerial shortcomings.

43. In 1961, the average current liability of a failing business was $57,182.00. The average varied by classes of industry as follows:

Manufacturing	$118,205
Wholesale trade	51,800
Retail trade	34,145
Construction	71,358
Commercial service	42,140
Canadian average	$ 57,182

Source: Research Division, Dun & Bradstreet of Canada Ltd., Toronto.

44. Though failures by size of failing company is not given, it may be presupposed from the above, that most companies would fall within the definition of small business used in this submission.

45. The record of failures and their attribution to managerial shortcomings highlight the non-financial needs of small business; in other words lack of capital is only one of a series of problems facing small business. Frequently the uppermost problem may be non-financial and may be a function of a lack of administrative or technical skill. Unless non-financial problems can be overcome, the introduction of more capital will do no more than postpone awareness of the more fundamental problem, whatever it may be.

46. It seems clear that any source of long term debt and equity capital should be in a position to offer non-financial assistance if needed to small business in order to safeguard and improve its investment. Further it would seem appropriate that whatever arm of the government is concerned with small business provide management aids by way of literature, regional meetings, advice on exports, advice of management techniques, tuition through universities and vocational schools, etc. Some assistance is being given in the export field, through the Department of Trade

and Commerce and Trade Commissioners offices. Some publications, such as the Small Business Manual, published by the Department of Trade and Commerce, have been made available through the Queen's Printer. A greater intensification of effort is required. It is understood that at present small business management requesting information from the Federal government frequently has to be referred to U. S. publications, as Canadian equivalent of the same are non-existent.

47. As will be suggested later, a solution would appear to be to focus all government activities directed towards small business into one organization, which would make its services, both financial and non-financial, widely known and available to small business. The non-financial services would be essentially educational and informational and would be directed towards improving the quality of small business management; through such an effort the efficiency and competitiveness of small business could be improved.

48. Political attitude towards small business

The devotion with which small business is treated politically has its genesis in the myth that our economy is still based on the ideal of pure competition wherein a multitude of small business entities compete in the market place. The reverse of the same myth hounds big business as being predatory, using monopolistic pressures to harm all who deal with it. The emotionalism of this issue, particularly in the U. S., has been brilliantly analyzed in Glover's, "The Attack on Big Business."[1.] As Glover points out, this is material out of which political platforms are formed. "Small and independent business is the backbone of American free enterprise. Upon its health depends the growth of

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1. J. D. Glover - The Attack on Big Business. Division of Research, Graduate School of Business Administration, Harvard University, 1954.

[illegible]

or [illegible], have been made available through the [illegible]'s [illegible], [illegible] greater intensification of effort is required. It is understood that [illegible] small business [illegible] remunerative [illegible] [illegible] Federal government [illegible] [illegible] [illegible], as [illegible] equipment of the [illegible]

[illegible] would appear to be [illegible] account [illegible] toward [illegible] business [illegible], [illegible] its [illegible], both financial and non-financial, already [illegible] available [illegible]. The [illegible] financial [illegible] would be [illegible], [illegible] and informational and would be [illegible] [illegible], the quality of small business management [illegible] [illegible] the [illegible] efficiency and competitiveness of small business could be improved.

Political attitude towards small business

The [illegible], which small business is [illegible] politically [illegible] in [illegible] that our [illegible] is still based on [illegible] of [illegible] small business [illegible] in the market place. The [illegible] of [illegible] bounds his [illegible] as being [illegible] [illegible] [illegible] to [illegible] all who [illegible]. The [illegible] [illegible] this [illegible], particularly in the [illegible], has been [illegible] [illegible] in [illegible], [illegible].[1] [illegible] [illegible], the [illegible] political [illegible] [illegible]. "Small and independent business is the backbone of American free enterprise. [illegible] its health [illegible] the growth [illegible]

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[1] [illegible]

the economic system whose competitive spirit has built this nation's industrial strength and provided its workers and consumers with an incomparably high standard of living.... We reaffirm our belief in the necessity of rigorous enforcement of the laws against trusts combinations and restraints of trade, which laws are vital to the safeguarding of the public interest and of small competitive businesses against monopolies, etc." Extract from the 1952 Platform of the U. S. Democratic Party.

49. Is big business really destroying small business and the opportunity for entrepreneurial endeavour by the individual? Is government intercession required to save small business? Studies on industrial concentration in the U. S. appear to indicate that no violent changes are taking place. As might be expected in certain industries the degree of concentration is high, an oligopolistic situation exists and small business participation is realistically precluded. In other industries the reverse is true. An analysis of industrial concentration in the United States summarizes this as follows: "1) The American economy is highly concentrated. 2) Concentration is highly uneven. 3) The extent of concentration shows no tendency to grow, and it may possibly be declining. Any tendency either way, if it does exist, must be at the pace of a glacial drift."[1.]

50. The cry to "do something" for small business has always had political appeal. The danger inherent in political action, however, is that in an effort supposedly to benefit the largest possible number of citizens, legislation may be considered which would tend to protect rather than to encourage, thereby fostering uncompetitive business at the total economy's inevitable expense.

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1. "The Measurement of Industrial Concentration", Dr. A. Adelman, Review of Economic Statistics, November, 1951.

51. Besides the danger inherent in the political attitude to create protective rather than encouraging legislation, there is the present danger in Canada that small business legislation would by necessity have to be based on insufficient knowledge of the problem which is being legislated. At this time, with our present knowledge of small business financial needs, legislation would take on an Alice in Wonderland complexion: "When the Queen of Hearts cried, 'Sentence first - verdict afterwards' Alice said loudly, 'Stuff and nonsense - the idea of having the sentence first.'"

52. <u>Potential improvements in the supply of long term debt and equity capital for small business</u>

Lack of specific knowledge of the nature of demand makes it difficult to propose how appropriate sources of capital might be created. Assuming, however, that what is broadly indicated in this report is indeed true, a shortage of long term debt and equity capital for small business exists in Canada and the capital market has not met the challenge of meeting the demand.[1.] Assuming that it is economically and socially desirable to create a greater flow of savings into this sector, the experience of other countries in diverting savings towards small business should be studied. The most notable experiment, and one which is both geographically and chronologically closest to us, is the American legislation which brought about the formation of a multitude of Small Business Investment Companies within the last two years.

53. Small Business Investment Companies were first defined by an Act of Congress in August, 1958,[2.] the purpose of which was: "To make equity capital and long-term credit more

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1. The reasons are documented in great detail in volume 1 of <u>Financing Small Business</u>, Report to the Select Committees on Small Business, April, 1958.

2. Public Law 85-699, 85th Congress, August 21, 1958.

readily available for small business concerns, and for other purposes." In summary, the Act provides for the following:

A.) Minimal Small Business Investment Company (S.B.I.C.) under the Act:

1) Minimum capital $150,000 paid in.

2) Small Business Administration (S.B.A.) will match this by purchasing $150,000 of debentures from S.B.I.C.

3) In addition S.B.A. may lend S.B.I.C. an amount equal to 50% of its paid in capital, and surplus (including the $150,000 debentures).

B.) To attract funds to S.B.I.C.'s the Act provides for certain tax benefits:

1) Should a stockholder of a privately or publicly owned S.B.I.C. sell his shares at a loss, he may offset this loss against his ordinary income to the full extent of the loss, rather than as an offset against a comparable gain. This particular tax feature is of relatively greater significance to individuals in higher income tax brackets.

2) Realized gains on the sale of S.B.I.C. shares are taxable at the usual capital gains rates.

3) Should an S.B.I.C. incur a loss on one of its investments, it may offset this loss against ordinary income instead of against capital gain.

4) Any S.B.I.C. may elect to be taxed as a regulated investment company under the Investment Company Act of 1940. If such an election is made there is no corporate income tax on the amounts distributed to shareholders as ordinary dividends provided that at least 90% of the S.B.I.C.'s gross income is derived from interest, dividends and capital gains, and is distributed to shareholders. (Certain other provisions not discussed).

5) Dividends received by an S.B.I.C. upon stock of a domestic small business concern is non-taxable (except in a year in which the S.B.I.C. elects and qualifies to be taxed as a regulated investment company).

54. These are important tax incentives within the framework of the U. S. tax structure and since an amendment in June, 1960[1.] when the investment powers of S.B.I.C.'s was broadened, funds have flowed quickly into a large number of newly incorporated S.B.I.C.'s. As of January 17, 1962, $269,064,094 had been invested in 40 S.B.I.C.'s through public offerings and $9,671,506 had been invested in 28 S.B.I.C.'s through private offerings, subsequent to the accumulation of initial capital by such companies.

55. Due to their newness, S.B.I.C.'s are not fully invested as yet and are not borrowing heavily from the S.B.A. Total investments made by S.B.I.C.'s through March 31, 1961 were $84,736,518, $45,069,706 or 53% of which was equity financing, the balance being term loans. Non-manufacturing industries accounted for 30% of the equity investment and 75% of the term loans. The heavy preponderance of term loans in the non-manufacturing segment is due to loans in the construction and real estate industry. Manufacturing accounted for 70% of the equity investment, with large aggregate investments being made in the field of scientific equipment, metal products, electrical machinery and chemicals and allied products. The size classification of business most heavily invested in is business with 100-249 employees and gross revenues in a range of $500,000 - $999,999, which is a size classification in which rapid growth is often experienced, and such growth naturally requires external capital.

56. Statistics are also available on the profit and loss performances of S.B.I.C.'s in three size categories: 1) licensed companies with capital and surplus of not more than $325,000, 2) licensed companies with capital and surplus of $325,000 - $1,000,000, and 3) licensed companies with capital and surplus

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1. Public Law 86-502, 86th Congress, June 4, 1960.

[illegible] important [illegible] the [illegible] the S. [illegible] structure and [illegible] in June, 19[illegible]

[illegible]

[illegible] lied [illegible] of [illegible]

S.B.I.C.'s [illegible] of January [illegible], 19[illegible], [illegible] had been [illegible] vested in 40 S.B.I.C.'s through public [illegible] and [illegible] had been invested in [illegible] S.B.I.C.'s [illegible] subsequent to the accumulation of initial capital by such companies.

[illegible] S.B.I.C.'s [illegible] financing [illegible] from the S.B.A. Total investments made by S.B.I.C.'s through [illegible] were [illegible], [illegible] of which [illegible] equity financing, the balance being term loans. [illegible] accounted for [illegible]% of the equity investment [illegible] of the [illegible] loans. The heavy [illegible] in the [illegible] is due to [illegible] construction and real estate [illegible]. Manufacturing accounted for [illegible] of the equity investment, with large [illegible] in the field of [illegible] and [illegible] chemicals and allied products. [illegible] have most [illegible] lowest [illegible] business [illegible] and gross revenues [illegible] size classification [illegible] and such [illegible] capital.

[illegible] are also available [illegible] performances of S.B.I.C.'s in three size categories: 1) licensed companies with capital [illegible] of not more than [illegible]; 2) [illegible] companies [illegible] capital and [illegible] of $[illegible] - $1,000,000 [illegible] 3) licensed companies with capital and [illegible]

[illegible]

in excess of $1,000,000. Though the experience has, of necessity, been short, it is interesting to note that only the largest size category has shown a consistent profit. This suggests that in order to operate efficiently, substantial capital must be under administration so as to cover the overhead costs of salaries, office expense, professional fees, travel, etc. In fact only recently there have been some mergers among S.B.I.C.'s, seemingly motivated by the desire to consolidate more assets under one management.

57. The fundamental advantage of the S.B.I.C. program has been the establishment of an entirely new class of investment company, which combining private or corporate savings with government support, has established a source of long term credit and equity funds for small business. This has been achieved by the U. S. government without substantial administrative costs to itself and without the imposition of government directives in the operation of S.B.I.C.'s. Though the companies are regulated, they are given broad scope within which to operate. Finally S.B.I.C.'s have diverted personal savings into small business financing, through the inducement of considerable tax incentives.

58. Clearly in this U. S. experiment, Canada has the ideal circumstances for observation of how savings can be diverted toward small business investment. The continued experience of American S.B.I.C.'s and the legislation governing them should provide most valuable guides towards whatever legislation Canada may wish to undertake in this field.

RECOMMENDATIONS

59. Assuming that after a comprehensive study of the financial needs of small business it is indicated that a void exists in the capital market insofar as availability of long term debt and equity capital to small business is concerned, a mechanism should be evolved to meet the evident demand.

60. It is recommended that the mechanism be provided through legislation which would create a new class of investment company devoted to small business investment. The basic characteristics of such investment companies are suggested as being:

1) Minimum size; a size limitation is recommended so that assets are large enough to allow for:

   (a) diversification of risk and still maintain ability of making substantial individual investments (i.e. if a limit of 10% of total assets is placed upon any one investment holding, and if investments up to $1,000,000 are to be considered, $10,000,000 of total assets would be required),

   (b) management, which would be large and strong enough to analyze investment opportunities and follow through on investments already made. Management should be flexible enough to step in and help direct certain aspects of company operation if need be.

2) Management should take risks as it sees fit within the basic policy defined for such an investment company and be judged by the results generated. It is assumed that such an investment company, though operating under specific legislation, would not be government controlled.

3) Investment company should be started on the premise that results cannot be achieved in less than three to five years, and that results should be anticipated through capital appreciation rather than income.

61. In order to attract funds into such an investment company, certain inducements should be offered. It is felt that as far as possible these inducements should avoid tax concessions and unnecessary complexities. Two basic inducements are recommended:

1) Investment company be empowered to borrow funds from a new crown corporation, at a reasonable rate of interest related to the Bank of Canada rediscount rate. Such borrowings would be made up to a predetermined ratio of paid in capital and surplus of the investment company and should be at least in the order of 50% of that amount. The risk of the borrowing would remain with the investment company, which would supply security to the crown corporation by way of pledging its investment holdings.

2) In order to give recognition to the risks assumed by the investment company, it should be given the privilege of writing off any capital losses against any taxable income, over a sufficiently long period so that this provision would be meaningful. A period of up to ten years is suggested.

62. It is suggested that though a demand for such an investment company's services exist, the demand is not sufficiently broad to justify encouraging a large number of investment companies to be formed. It would be desirable to limit the number of investment companies to perhaps no more than five or six at the outset. With an average investing power of $10,000,000 minimum, this would be a fund of about $60,000,000, made up of $40,000,000 paid in capital and $20,000,000 borrowings from the crown corporation.

63. It would further seem desirable that such investment companies should be formed by existing financial institutions. There are at present groupings of banks, trust companies, and insurance companies in the Canadian economy; these groupings, which presuppose a working relationship, could spawn the proposed investment companies, and lower cost of operations by the sharing

of certain facilities. American S.B.I.C. experience already indicates the feasibility of associating such investment company operations with that of a commercial bank.

64. It is recommended that a new crown corporation be formed so as to make loans available to the proposed investment companies. The functions of the new crown corporation, however, are suggested to be much broader; it should assume the direction of all government activities in the small business field. For instance, in order to insure the effectiveness of the proposed investment companies along side the existing Industrial Development Bank, it is suggested that the Industrial Development Bank become responsible to the new crown corporation and that its activities be limited to acting as a mortgage bank to small business. In this manner the Industrial Development Bank would complement rather than conflict with the role envisioned for the proposed investment companies.

65. It is recommended that besides its financial functions, the new crown corporation would perform important educational and informational functions in the small business field. As previously pointed out, small business failures stem more from managerial shortcomings than financial shortcomings. A great need exists to improve the managerial capacity and skill of small business. The type of service which it is recommended the new crown corporation should perform include the following:

1) Stimulate education in business management.

   (a) Through the encouragement of educational programs at present institutions such as universities and vocational schools.

   (b) Regional meetings which would encourage small business management to discuss their problems and learn from their collective experience.

2) Stimulate small business management contact with government.

(a) So that small business can get its share of government contracts, including defense work.

(b) So that small business can maximize its export trade potential.

(c) So that small business can become fully aware of government research work, such as the work of the National Research Council, etc.

3) Supply informational services,[1] so that small business is aware of -

(a) New management techniques.

(b) New taxation and tariff policies which may effect it.

(c) New business opportunities due to technological change.

4) Supply data collecting services - so that small business may know more about itself and so that its interests can be served on the basis of factual information.

5) Act as a coordinating body which would endeavour to help and stimulate provincial development programs in the small business area.

66. In summary, the new crown corporation's non-financial functions would dominate its financial utility. This seems entirely in order for it is the opinion of this submission that the financing of small business should be left to private initiative, even if it has to be stimulated by certain proposed legislation. The educational and informational aspects of small business, however, are more properly a government function. It is an important function for it can improve the competitiveness of small business and thus effect the vitality of the entire economy.

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1. It is interesting to note that in the United States at least one commercial bank, the Bank of America, is performing this service through a division called Small Business Advisory Service.